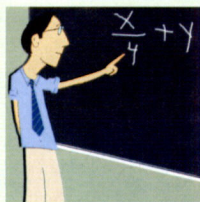


## BASICS



# Microfinance: Banking for the Poor

Ina Kota

**M**UFIYA Khatoon—a poor, illiterate young woman in rural Bangladesh—used to spend her days begging for a few ounces of rice to feed her children. She desperately wanted a livelihood, but lacked the funds to start a small business, and there was nowhere she could borrow on terms she could afford. That is, until she discovered Grameen Bank, one of the first microfinance institutions (MFIs), which set up shop in rural Bangladesh in the wake of the 1976 famine. In 1979, Grameen made Mufiya a one-year loan of 500 taka (about \$22), enough to start a bamboo business. To qualify, she had to form a group with four others in similar circumstances. She paid an interest rate of 20 percent, with repayments of 2 percent of the loan each week. Stiff terms perhaps, but better than the 150 percent interest rate a local money lender would have demanded. Mufiya was able to start her bamboo products business and, one year later, she repaid her loan. She is better off materially and more in control of her own destiny.

Microfinance gave Mufiya—as it did to millions of other poor people with no credit history, collateral, or steady income—access to basic financial services. Half of the world's population, nearly three billion poor people, lack such access. Most mainstream banks have considered the poor high-risk and hard to serve because they often live scattered across remote areas and because the small loans they need are costly to make and maintain. But microfinance, which specializes in providing small loans and other financial services even to the world's most destitute, challenges those traditional assumptions.

In the past three decades, microfinance has mushroomed from Grameen's tiny nonprofit experiment in Bangladesh to a global industry. Grameen Bank and its founder Muhammad Yunus won the 2006 Nobel Peace Prize for pioneering efforts to provide financial services to the poorest of the poor. Many enthusiasts believe microfinance is an important tool in the effort to end world poverty. Whether they are right is still open to question.

### The current landscape

Today, microfinance players include governments, philanthropists, social investors, and commercial banks, such as Citicorp and ING, that are attracted by the potential for profit and corpo-

rate social responsibility. Customers can still go to a Grameen-type bank, but they can also go to microfinance credit unions, public sector and commercial banks, and, relatively recently, Islamic banks (which apply Islamic financial principles, such as risk sharing). Besides tiny business loans, MFIs offer deposit, savings, pension, and insurance products. Microinsurance is growing because borrowers need to insure assets such as farming equipment that they purchase with microcredit. In fact, MFIs are as important in providing savings vehicles and transaction services as they are in lending.

Microfinance customers live in both rural and urban areas—the rural poor borrow for cattle fattening, dairy farming, bamboo making, or weaving, whereas the urban poor borrow to become street vendors, rickshaw drivers, or seamstresses. Moreover, microfinance has moved well beyond its roots in developing countries—some MFIs now serve poor people in industrial countries.

Still, reliable data are hard to come by. The number of MFIs operating today is estimated to range anywhere from 300 to 25,000, depending on the definition. The Microfinance Information eXchange (MIX), known as the “Bloomberg” of microfinance, reports on nearly 1,000 microfinance institutions worldwide, nearly half of which are self-sustainable. The number of borrowers is hard to pin down, with estimates ranging from 30 to 500 million. The Washington D.C.-based advocacy group Microcredit Summit Campaign verified

### Big business

The Microcredit Summit Campaign says microfinance has shot up globally in just the past six years.

Year	Number of institutions verified	Number of poorest clients verified
2000	78	9,274,385
2001	138	12,752,645
2002	211	21,771,448
2003	234	35,837,356
2004	286	47,458,191
2005	330	58,450,926
2006	420	64,062,221

Source: State of the Microcredit Summit Campaign Report (2006).



more than 64 million worldwide in 2006, up from more than 9 million borrowers in 2000 (see table). Many more millions of poor people have their savings in MFIs.

### How it works

MFIs assume that their clients are clever enough to handle their own affairs, but do not assume that all the poor will be reliable borrowers. They have adopted two basic approaches:

## **"It will be challenging to achieve sustainability while reaching the remote rural poor, especially those at the bottom of the income ladder."**

**Group lending.** Grameen Bank is considered the pioneer of the group lending model, which has now been adopted in many countries. Individual borrowers are required to form a group and take responsibility for each other's loans. Grameen Bank depends primarily on peer pressure to guarantee repayment. Moreover, it limits risk by targeting female borrowers, who are considered more reliable because of family-based community ties. In early 2007, Grameen Bank reported almost 7 million borrowers—96 percent of them poor, illiterate women from remote villages. And since 1976, it says, \$6 billion has been lent, with a repayment rate of 98 percent.

**Individual lending.** These loans are bigger and are made to individuals without a collective guarantee and on more flexible terms. Typical borrowers are not the very poor seeking to start businesses, but the self-employed poor who are skilled business people. In some cases, the borrower has a small amount of collateral. Accion, a leading MFI that operates in Latin America and the Caribbean, Africa, and Asia, has adopted individual lending in the form of small, short-term loans of \$100 to \$500 at interest rates that it says reflect the cost of lending. Loan officers look not only at a borrower's financial wherewithal but also at references from customers and neighbors. Incentives such as the possibility of borrowing progressively larger amounts and the opportunity to get business and vocational training encourage repayment. In countries like Bolivia, credit bureaus have been set up to enforce repayment.

### The road ahead

Although microfinance appears to be a promising way to provide financial services to the poor, there is considerable debate about its future.

**Is microfinance sustainable?** If microfinance can achieve commercial success, it can move beyond relying on subsidies, which today total hundreds of millions of dollars. MFIs are expected to increase their reach among the urban poor—who, because they are concentrated, are easier to serve. But it will be challenging to achieve sustainability while reaching the remote rural poor, especially those at the bottom of the income ladder, because of the high costs and risks involved.

**Should microfinance be sustainable?** A microfinance movement that becomes mainly commercial might shift its focus from the poorest borrowers to relatively better off, more conventionally safe customers. Thus, MFIs may evolve into direct competitors with conventional banks, and the special benefit for the poorest may be lost in the search for commercial sustainability. Yet in some locations, heavily subsidized MFIs may be crowding out sustainable MFIs, and the subsidies may therefore be of little additional benefit. One may also ask whether MFIs should concentrate on the poorest borrowers, or are other mechanisms better, given constraints on aid budgets?

**Why are interest rates so high?** The interest rates on microloans range from 20 percent to 35 percent (even after adjusting for inflation). MFIs are subject to significantly higher costs than commercial banks, because of lending and administrative costs (for example, identifying and screening clients). For some MFIs, interest rates cover the cost of doing business, whereas others add a premium for risk. Some say that despite the high interest rates, the loans still provide positive welfare benefits for borrowers and that costs will fall as the infrastructure of the industry grows. There is a broad consensus that increased competition is the key to driving down interest rates.

**What regulatory and legal framework is necessary?** The regulatory and legal approach used for large-scale commercial financial institutions may not be appropriate for microfinance. Countries such as Morocco and Kenya have developed legal frameworks to regulate MFIs. Key challenges are how best to protect depositors and borrowers while promoting the MFI sector, how to limit the costs of MFI supervision, and how to prevent regulation from restricting innovation and competition. What, for example, is the balance between consumer protection, the regulatory burden, and sustainability and development?

### Goin' digital

Technology may provide some answers. Today, "branchless banking" is active in the Philippines, South Africa, and Colombia. Commercial players are using point-of-sale devices and mobile phones to connect with the rural poor, licensing local merchants and shop owners to make cash transactions on their behalf. The availability of such transfer services is especially important in areas where families rely on remittances from relatives working in economic centers or abroad. Technology will likely reduce transaction costs, allowing MFIs to grow and reach more customers.

The latest innovation is the digital microfinance marketplace, where Web-based MFIs like Kiva.org team up with local credit providers to match low-income borrowers with higher-income social investors—individual lenders who make electronic loans for amounts as small as \$25. One potential borrower, Zemfira Bayramova of Azerbaijan, can advertise her need for \$1,000 to buy three calves. Once \$1,000 has been received, the funds are sent to a local partner, Komak Credit Union, which disburses the funds to Zemfira. Kiva.org claims to have processed nearly \$5 million in loans in April 2007, up from \$400,00 in October 2006. ■

*Ina Kota is on the staff of Finance & Development.*